IN THE

Supreme Court of the United States

October Term, 1977

No. 77-1811

ALLIED FIDELITY CORPORATION, f.k.a., William E. Roe, Allied Agents, Inc.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Civil No. 77-1415

PETITION FOR WRIT OF CERTIORARI to the United States Court of Appeals for the Seventh Circuit

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PETITION FOR WRIT OF CERTIORARI to the United States Court of Appeals for the Seventh Circuit

Petitioner prays the Supreme Court to grant a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in the above-entitled case on March 23, 1978.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit is not yet officially reported but is unofficially reported at 78-1 U.S.T.C. ¶ 9325 and at 41 AFTR2d 78-528, and is presented in Appendix A hereto, *infra* page A-1. The opinion of the United States Tax Court is reported at 66 T.C. 1068 and is presented in Appendix B hereto, *infra* page B-1.

calendar years since its incorporation, filed with the insurance departments and commissioners of each of such states an Annual Statement on the form approved and adopted by the National Association of Insurance Commissioners (formerly known as the National Convention of Insurance Commissioners). For the years 1969 through 1974, AFIC reported premiums, losses and expenses relating to its surety bail contracts as items of insurance. The Annual Statements thus filed by AFIC for each of such years were, in form and content, as prescribed by the insurance laws of Indiana and of the other states in which AFIC was authorized to conduct its business as an insurance company.

AFIC's internal method of accounting and its method of accounting for tax purposes have been consistent with the methods used on the Annual Statement and with generally accepted principles of accounting in accordance with accepted conditions or practices of insurance companies.

During the above-mentioned years, AFIC engaged in no activity other than the lines of business authorized in its Articles of Incorporation and under the insurance laws of Indiana and the other states in which it was licensed to transact an insurance business.

In auditing Allied's consolidated federal income tax returns, the Commissioner of Internal Revenue (the "Commissioner") took the position that AFIC's surety bail contracts were not insurance contracts and that because AFIC's business consisted primarily of underwriting such contracts, it failed to qualify as an insurance company for the taxable years in issue.

Based on this determination, the Commissioner asserted the following deficiencies against Allied with respect to its consolidated returns for the taxable years indicated:

Taxable Year Ended	Asserted Deficiency
December 31, 1971	$26,900.86
December 31, 1972	75,368.20

Allied brought an action in the United States Tax Court seeking a redetermination of the alleged deficiencies.

Federal jurisdiction in the Tax Court is based upon section 6214(a) of the Code (26 U.S.C. § 6214(a)), which grants the Tax Court jurisdiction to redetermine the correct amount of the deficiency, notice of which has been mailed to the taxpayer.

The Tax Court affirmed the Commissioner's determination and held that Allied had income tax deficiencies for its taxable years ended December 31, 1971 and December 31, 1972 in the amounts of $26,586.57 and $73,592.10, respectively. The United States Court of Appeals affirmed the decision of the Tax Court in an opinion issued on March 23, 1978.

REASONS AND ARGUMENT FOR ALLOWANCE OF THE WRIT

Allied submits that this Court should exercise its discretion to grant review on writ of certiorari because the court of appeals has rendered a decision on an important question of federal law which has not been, but which should be, settled by this Court, and because the court of appeals' decision with respect to that federal question is based upon conclusions of law which are in conflict with applicable decisions of this Court.

An Important Federal Question Is Involved

The issue raised by this case involves a novel and important question concerning the interplay between state insurance laws and federal tax law. AFIC was licensed as an insurance company in Indiana and regulated as such by the Insurance Commissioners of the five states in which it transacted business during the tax years at issue. The Insurance Commissioners of two of those states, Indiana and Utah, specifically stated, in certificates authorizing

AFIC to carry on its business, that included within the classification of "insurance" permissible in those states was the writing of surety bail. Indeed, of the 43 other state insurance laws which define "insurance " or "surety insurance," surety-bail contracts fall within the definitions of each of these. Yet, the Tax Court has held, and the Seventh Circuit has affirmed, that, for federal tax law purposes, surety bail contracts are not contracts of insurance and that, therefore, AFIC was not entitled to be taxed as an insurance company.

If allowed to stand, this determination, in a case acknowledged to be one of first impression, will have a profound and adverse impact on the insurance industry. It would disqualify as an insurance company for federal income tax purposes, and (by reason of the additional tax liability) thereby possibly render insolvent, other members of the property and casualty insurance industry now primarily engaged in writing surety bail contracts. It would also substantially undermine the ability of insurance companies of every kind and class to rely upon rules and practices of State Insurance Commissioners as controlling in determining which lines of their business will be treated as insurance for federal income tax purposes and thus be subject to the Annual Statement method of accounting provided by section 832 of the Code.

Nor is the above description of the adverse impact of the court of appeals' decision merely theoretical. It motivated the filing of a Brief *Amicus Curiae* in the court of appeals by the National Association of Independent Insurers, a non-profit trade association composed of more than 600 property-liability insurance companies, doing business in every state and having combined premium volume of $23 billion in 1975. Furthermore, Allied has been advised that the Internal Revenue Service has, since the decision of the Seventh Circuit in this case, taken the position that other types of surety and fidelity insurance coverages, which involve a far greater volume of business and which have long

been recognized to be insurance, do not qualify as insurance for purposes of sections 831 and 832 of the Code. The result is that companies writing these lines of business will not be entitled to insurance accounting treatment of such items as premiums, losses and loss adjustment expenses with respect to these lines, even where such lines do not comprise the majority of the company's business. Moreover, where a company is engaged primarily in underwriting these lines, its status as an insurance company for tax purposes will be called into question.

Given the tremendous impact which the decision of the court of appeals will have on the federal income tax liability of property and casualty insurers, it is submitted that a significant federal question is involved, necessitating the granting of this petition for a writ of certiorari.

The Lower Court's Decision Conflicts With Applicable Decisions of this Court

In holding that AFIC was not an insurance company, the court of appeals relied upon Treas. Regs. § 1.801-1(b) which defines the term "insurance company" as follows:

> "Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Code."

However, in applying this regulation, the court of appeals relegated the first three factors mentioned therein—name, charter powers and subjection to state insurance laws—to a position of relative insignificance in determining the nature of AFIC's business. (App. p. A-3, 4) As a result, its decision conflicts with prior decisions of this Court from which the above-quoted treasury regulation was derived.

The first of these decisions was *United States* v. *Cambridge Loan and Building Company,* 278 U.S. 55 (1928), in which the issue was whether the taxpayer qualified as a "domestic building and loan association" within the meaning of section 231 of the Revenue Act of 1918. No definition of those words was provided by the statute. The Supreme Court, in an opinion of Mr. Justice Holmes, noted that the taxpayer was incorporated under the laws of Ohio, by which it was recognized as a building and loan association, and that it had conducted its business in accordance with the laws of that state. In holding that the taxpayer qualified as a domestic building and loan association within the purview of the Revenue Act, the Court stated:

> "It is argued that even admitting all that has been said thus far, a State cannot make a bank exempt merely by calling it a building and loan association. No doubt extravagant cases might be imagined. *But these associations are well known and a State is not likely to be party to a scheme to enable a private company to avoid federal taxation by giving it a false name.* The statutes speak of domestic associations, that is, associations sanctioned by the several States. *They must be taken to accept, with the qualifications expressly stated, what the States are content to recognize, unless there is a gross misuse of the name.*" (278 U.S. at 59; emphasis added)

This opinion was followed by *Bowers* v. *Lawyers Mortgage Co.,* 285 U.S. 182 (1932), where the Supreme Court was faced with the question whether the taxpayer there involved should be permitted to be taxed as an insurance company. The facts recited in that case show that the taxpayer had originally been incorporated under the Insurance Laws of New York. However, the company actually engaged in the banking business and not the insurance business. Indeed, it had dropped the word "insurance" from its name 20 years prior to the tax years at issue.

In reviewing the law applicable to a determination of whether Lawyers Mortgage qualified as an insurance company, the Court set forth the test which has since been incorporated into Treas. Regs. § 1.801-1(b):

> "While name, charter powers, and subjection to state insurance laws have significance as to the business which a corporation is authorized and intends to carry on, the character of the business actually done in the tax years determines whether it is taxable as an insurance company." (285 U.S. at 188)

Turning to the specific facts involved, the Court stated:

> "The dropping of 'insurance' from respondent's name and the extension of charter powers to the purchase and sale of mortgage loans suggest a purpose to carry on an investment rather than an insurance business. Respondent did not consider itself an insurance company taxable under § 246 until after it had twice made and paid capital stock taxes under § 1000(a) and income taxes under § 230.
>
> * * *
>
> "Respondent's business is one which may be and is in fact carried on by corporations organized under the New York banking laws. The element of insurance may not properly be regarded as more than an incident thereof; it certainly is not sufficient to make respondent an 'insurance company' within the meaning of that phrase as it is commonly used and understood. There is no warrant for holding that Congress intended to use the expression in any other sense." (285 U.S. at 188-190; citations omitted)

Significantly, the Court also cited with approval the *Cambridge Loan and Building* case, noting that in that case the taxpayer's activities had not constituted a "gross abuse" of its name, whereas, by implication, the extensive banking activities carried on by Lawyers Mortgage would have

companies and the lines of business which they write are not insurance business.

In addition, the court of appeals' decision conflicts with relevant decisions of this Court in another important respect: in applying the fourth test of Treas. Regs. § 1.801(b) —"the character of the business actually done"—the court of appeals has construed the surety's obligation under a surety bail contract in a manner which is directly contrary to this Court's holdings.

The court of appeals' holding that surety bail bonds do not qualify as "insurance" and that a company which engages primarily in the writing of surety bail bonds cannot qualify as an insurance company for tax purposes is grounded in the premise that a surety's obligation under a surety bail contract involves the performance of a service (producing the accused at trial), rather than the assumption of an economic risk, which is said to be the essential ingredient of an insurance contract (App. p. A-5, 6)

Yet, decisions of this Court as to the obligation of a surety under a contract of bail dictate precisely the opposite conclusion. More than 65 years ago, Justice Holmes described the obligations under a bail bond contract as follows in the case of *Leary* v. *United States*, 224 U.S. 567 (1912):

> "It is said that the bail contemplated by the Revised Statutes (§ 1014) is common-law bail and that nothing should be done to diminish the interest of the bail in producing the body of his principal. But bail no longer is the *mundium,* although a trace of the old relation remains in the right to arrest. Rev. Stat., § 1018. The distinction between bail and suretyship is pretty nearly forgotten. *The interest to produce the body of the principal in court is impersonal and wholly precuniary.* If, as in this case, the bond was for $40,000, that sum was the measure of the interest on anybody's part, and it did not matter to the Government what person ultimately felt the loss so long as it had the obligation it was content to take." (224 U.S. at 575-576; emphasis added)

The conflict between the court of appeals' holding and this Court's decisions as to the obligation of a surety under a surety bail contract is even more graphically illustrated in the case of *Continental Casualty Co.* v. *United States,* 314 U.S. 527 (1942). There Continental had posted bond for an individual who had failed to appear when required, and the amount of the bond had been forfeited. Continental sought to have the forfeiture remitted under a statute which allowed such remission where the default under the bond contract was not willful. The lower court held that the forfeiture could not be remitted, reasoning that although Continental had acted properly, the principal's failure to appear had been willful. The Supreme Court affirmed, stating:

> "It appears to us that there can be but one person who can willfully default within the meaning of the section. This is the principal in the recognizance. By its terms he agrees to 'appear for judgment.' When, without excuse, he fails to appear, there is a willful default. *The surety only guarantees that the principal will not default. In a certain sense the surety may default by failure to pay its obligation, but this is plainly not the kind of default to which the statute refers."* (314 U.S. at 530; emphasis added)

Simply stated, the Supreme Court found that a surety is not in default when the principal fails to appear; a surety is in default only when it fails to pay its obligation. Clearly this is recognition of the fact that the surety's obligation is *not* to perform a service (produce the principal); it is to pay the amount of the bond if the principal fails to appear. Thus the surety's interest is wholly economic.

In reaching a contrary conclusion, the court of appeals not only reached an erroneous result, but it also reached a decision which is in direct conflict with decisions of this Court.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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Appendices

APPENDIX A

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

No. 77-1415

ALLIED FIDELITY CORPORATION, f/k/a., William E. Roe, Allied Agents, Inc.,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court,
No. 8676-74—Theodore Tannenwald, Jr., Judge.

ARGUED NOVEMBER 3, 1977—DECIDED MARCH 23, 1978

Before FAIRCHILD, *Chief Judge;* SWYGERT, *Circuit Judge;* and GRANT, *Senior District Judge.**

GRANT, *Senior District Judge.* The single issue presented in this appeal is whether the wholly owned subsidiary of appellant, the Allied Fidelity Insurance Corporation (Allied), is entitled to be classified as an insurance company under the provisions of 26 U.S.C. §§ 831 and 832.

Allied, an Indiana corporation whose principal offices are located in Indianapolis, Indiana, exists as a wholly owned subsidiary of the taxpayer, Allied Fidelity Corporation.

* Senior District Judge Robert A. Grant of the United States District Court for the Northern District of Indiana is sitting by designation.

Since 1969 Allied has engaged primarily in the business of writing fidelity and surety bonds. During 1971, about 91% of Allied's business was in the writing of surety bail contracts and 9% in fidelity and other surety bonds. In 1972, about 64% of Allied's business was in surety bail contracts, about 10% in fidelity and other surety bonds, and the remaining 26% in automobile insurance. Allied amended its articles of incorporation during 1972 in order to permit the insurance of a wide range of casualty and other risks. Since its incorporation, Allied has filed annual statements with the insurance regulatory authorities of the states in which it was authorized to do business. For these purposes, Allied utilized forms approved by the National Convention of Insurance Commissioners and its tax accounting techniques were consistent with those Convention standards and other generally accepted accounting principles for insurance companies.

The appellant and Allied filed consolidated income tax returns for the years in question, 1971 and 1972. For both these returns, the taxable income was calculated in accordance with the provisions of the Internal Revenue Code, specifically 26 U.S.C. § 832. The appellee, Commissioner of Internal Revenue, determined that the appellant was deficient in its tax payments upon the basis that Allied was not an insurance company during 1971 and 1972 and that, as a result, § 832 did not apply. The tax liability owed was calculated to be $26,586.57 for 1971 and $73,592.10 for 1972.

Appellant brought an action in the United States Tax Court which determined on September 27, 1976, that Allied did not qualify as an insurance company during the taxable years in question for purposes of §§ 831 and 832 of the Code and that, therefore, its accounting treatment of certain income and deduction items was improper. The basis for this determination was the tax court's acceptance of the Commissioner's assertion that the writing of surety bail contracts, which constituted the majority of Allied's business, did not constitute the writing of insurance contracts.

Insurance companies, other than life and mutual, are taxed in accordance with the provisions of 26 U.S.C. §§ 831 and 832. Unfortunately, neither of these sections provides a definition of the term "insurance company". However, we do gain some guidance from the regulations promulgated under § 831 which define "insurance company" by reference to the definition in the regulations under § 801 of the Code. Treas. Regs. § 1.831-1(a) (1960). The regulations under § 801, as are relevant here, provide that:

> Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Code. Treas. Regs. § 1.801-1(b)(2) (1960).

This definition is the cumulative result of a series of cases decided in the late 1920's and early 1930's. *Bowers* v. *Lawyers Mortgage Co.*, 285 U.S. 182 (1932); *United States* v. *Home Title Insurance Co.*, 285 U.S. 191 (1932); *United States* v. *Cambridge Loan and Building Co.*, 278 U.S. 55 (1928). In *Bowers*, the Supreme Court was faced with the similar question of whether the taxpayer there involved should be permitted to be taxed as an insurance company. The Court established as its test the language which subsequently became incorporated into Treas. Regs. § 1.801-1(b):

> While name, charter powers, and subjection to state insurance laws have significance as to the business which a corporation is authorized and intends to carry on, the character of the business actually done in the tax years determines whether it is taxable as an insurance company. 285 U.S. at 188.

Appellant argues that the first three factors mentioned in the test should be given great and possibly even determinative weight. Yet, we feel that the language of the regulation

is plain and will give the proper deference to the expertise of the Internal Revenue Service in matters such as this. The phraseology of the regulation is clear. The first three elements, name, charter powers, and subjection to State insurance laws, should be "significant" in our evaluation. But, the "character of the business actually done" will be the standard by which we will determine if appellant is taxable as an insurance company under the Code.

There is no doubt that Allied's name included the word "Insurance". It is also clear that the company was organized under the Indiana insurance laws and that the corporate charter stated that Allied was organized for the purpose of writing the kinds of insurance and reinsurance specified in subdivision (k) of Class II of § 59 of the Indiana Insurance Law of 1935. The Certificate of Incorporation set forth the language of that statutory provision verbatim. In both Allied's original certification and its annual recertifications, the Insurance Commissioner specifically recognized that the statutory definitions of the types of insurance which Allied was authorized to write included surety bail bonds. While such characterizations may be significant, they are not controlling for the reason that a state classification of a corporation as an insurance company is not necessarily binding on the Commissioner for Federal tax purposes. *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974); *Bowers* v. *Lawyers Mortgage Co., supra; Oil Colony Railroad Co.* v. *Commissioner*, 284 U.S. 552 (1932). The result is that while we must keep the factors mentioned above in mind, we must, in the final analysis, review the nature of the system of bail and how it relates to the characteristics of an insurance contract before we can finally determine the "character of the business actually done" by Allied in 1971 and 1972.

As the bail system has developed in the United States, the accused may enjoy his freedom prior to trial if he gives sufficient monetary security as assurance that he will appear. If he fails to appear, the security is forfeited as

a penalty. *Stack* v. *Boyle*, 342 U.S. 1 (1951). It has become a practice for commercial institutions such as Allied to provide the amount of that monetary security upon payment of a fee by the accused. The theory adopted by the courts was that the bondsman's contract with the court requires him to produce the accused or suffer forfeiture of the monetary security as a penalty. Due to the bondsman's potential liability, he originally had broad powers over the person of the accused in order to assure his appearance before the court. *Taylor* v. *Taintor*, 16 Wall. 366 (1872). While appellant argues that this analysis of bail is outdated and contrary to modern realities of the industry, we must disagree. As recently as *United States* v. *Holmes*, 452 F.2d 249, 261 (7th Cir. 1971), we cited *Taylor* v. *Taintor* for the proposition that although an accused may be at large as a result of his having been admitted to bail, in contemplation of the law he remained in custody. *See also Continental Casualty Co.* v. *United States*, 314 U.S. 527 (1942); *United States* v. *Davis*, 202 F.2d 621, 625 (7th Cir. 1953).

Appellant also contends that the interest of the United States or the particular state exercising criminal jurisdiction over the accused is wholly pecuniary consisting of a purely financial arrangement. It seems to us that the exact opposite is true. The interest of the government is impecuniary and non-financial. That interest can be defined as seeing that those accused of crimes are tried and, if convicted, punished by the courts. Upon forfeiture, the payment to the United States, or to the courts of a state, is simply a penalty against the surety for failing to perform on its contract to produce the accused for trial. The interest in the criminal justice system is not economic but, rather, is the socially desirable end of properly punishing those convicted of crimes. The payment of a forfeiture by a surety cannot compensate the government for the loss of that goal.

On the other hand, the common definition for insurance is an agreement to protect the insured against a direct or indirect economic loss arising from a defined contingency

whereby the insurer undertakes no present duty of performance but stands ready to assume the financial burden of any covered loss. 1 COUCH ON INSURANCE 2D § 1:2 (1959). As the tax court below noted, an insurance contract contemplates a specified insurable hazard or risk with one party willing, in exchange for the payment of premiums, to agree to sustain economic loss resulting from the occurrence of the risk specified and, another party with an "insurable interest" in the insurable risk. It is important here to note that one of the essential features of insurance is this assumption of another's risk of economic loss. 1 COUCH ON INSURANCE 2D § 1:3 (1959).

Appellant argues that the insurable risk of the state in a criminal bail contract is an economic one. We cannot agree. The fallacy to appellant's approach is that they have analyzed the bail arrangement only from the point of view of Allied, ignoring the other two parties to what is essentially a tri-party arrangement. From Allied's position as surety, the transaction may appear to be essentially a pecuniary one but, as we have stated above, the loss to the state by an accused fleeing, which is the "risk" to the state, may be societal, legal, or moral, but certainly is not merely a pecuniary one. This is best exemplified by the fact that if a forfeiture payment by Allied were true insurance, that payment would make the state whole, fully compensated for its loss. Yet, as is obvious, the state can only be made whole by the recapture of the accused and the resulting vindication of the rights of society. For it is society that the criminal process protects and the payment of a sum by Allied does not satisfy that interest until the state regains the ability to punish those who break the law. Allied's principal obligation is to produce the accused at trial. The monetary obligation is merely an assurance of, or inducement to perform that principal obligation. *United States* v. *Ryder*, 110 U.S. 729, 734 (1884). Allied's contract thus resembles more a contract to perform services than a contract of insurance. The forfeiture of the surety's bond, if the accused fails to appear, is not

to reimburse the state for an economic loss but serves more as a penalty for the surety's own failure to perform.

Appellant also argues that under the definition established in *Helvering* v. *LeGierse*, 312 U.S. 531 (1941), Allied was involved in the writing of insurance contracts for federal income tax purposes. In *Helvering*, the Supreme Court analyzed certain types of life insurance contracts wherein it stated, "Historically and commonly insurance involves risk-shifting and risk-distributing." 312 U.S. at 539. Appellant argues that the "risk" of an accused failing to appear for trial is effectively shifted from the state to the surety because the cost incurred in apprehending a fleeing defendant is shifted to the surety. Further, the "risk" is effectively distributed among all of Allied's customers because the level of premiums is set at a level sufficient to cover all forfeitures.

Appellant cites *United States* v. *Foster*, 417 F.2d 1254 (7th Cir. 1969) and *United States* v. *Nell*, 515 F.2d 1351 (D.C.Cir. 1975), to support its position that the risk of the disappearance of the accused is borne by the surety. Both of these cases dealt with the factors which a District Judge could properly consider in making a determination to remit all or a portion of a forfeited bond pursuant to Rule 46 of the Federal Rules of Criminal Procedure. However, neither case can be said to stand for the proposition that the cost of reacquiring jurisdiction over the accused is borne by the surety.

Appellant also asserts that the risk distribution element of the *Helvering* test is met by Allied because the amount of premiums collected must be adequate to cover all forfeitures. Yet, the record does not reveal any evidence that the level of premiums are based upon any projections as to the amount of forfeitures incurred. Indeed, the pervasive general rule is that the charge to an accused for a corporate bail bond is simply a flat 10% of the bond. We also fail to see how the risk is distributed among all of Allied's customers when by contract, and in some states by

statute,[1] the individual defendant agrees to indemnify the surety for any forfeitures incurred.

A contract of bail requires the payment of a fee in exchange for the promise of the surety that the accused will appear. It also provides an amount to be forfeited upon the failure of that duty. It may, in fact, be more in the nature of a service agreement or a loan, but we are convinced that the tax court was correct in its determination that the writing of bail bond contracts, for federal income tax purposes, are not contracts of insurance. We are mindful of the fact that Allied remains subjected to state insurance laws and that its name and charter powers indicate its intention to operate as an insurance company. But the test established by Treas. Regs. § 1.801-1(b) makes it clear that "the character of the business actually done" will determine whether an entity is taxable as an insurance company. For the reasons stated above, we conclude today that for the taxable years in question Allied did not qualify as an insurance company for purposes of §§ 831 and 832 of the Code and that, accordingly, the tax court's determination that Allied's accounting treatment of certain income and deduction items was improper is affirmed.

While not specifically raised by the parties, we are cognizant of the fact that when the Commissioner determines that a company does not qualify under §§ 831 and 832 because of the fact that majority of its business involves the writing of bail bond contracts, such company will be penalized to the extent that it does not get the benefit of these tax provisions for its other types of genuine insurance activity. That situation is not here presented since the activities of Allied were predominantly in the area of bail bond contracts. Accordingly, what our position would be if a different fact situation were presented we do not now conclude.

AFFIRMED.

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[1] *See e.g.,* IND. CODE § 35-1-22-10 (1905).

APPENDIX B

UNITED STATES TAX COURT

ALLIED FIDELITY CORPORATION F.K.A. WILLIAM E. ROE, ALLIED AGENTS, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 8676-74. Filed September 27, 1976.

TANNEWALD, *Judge:* Respondent determined the following deficiencies in corporate income taxes with respect to consolidated returns filed by petitioner:

Year	Deficiency
1971	$26,900.86
1972	75,368.20

The issues for decision are:

(1) Whether Allied Fidelity Insurance Co. (hereinafter referred to as AFIC), a wholly owned subsidiary of petitioner, was an insurance company within the meaning of section 831[1] entitled to compute its income in the manner provided in section 832; and

(2) If AFIC is not taxable as an insurance company, whether its method of accounting clearly reflects income and was improperly disregarded by respondent.

All of the facts are stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner is an Indiana corporation whose principal offices were located in Indianapolis, Ind., at the time its petition was filed. AFIC has been a wholly owned subsidiary of the petitioner since AFIC was incorporated on July 22, 1969.

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[1] All statutory references are to the Internal Revenue Code of 1954, as amended and in effect for the years in issue.

Articles III and VII of the original articles of incorporation of AFIC stated its purpose and business plan as follows:

ARTICLE III

Purposes of the Corporation

Section 1. The Corporation is organized under the provisions of the Indiana Insurance Law of 1935, as amended (hereinafter referred to as the "Act"), for the purpose of writing the kind of insurance and reinsurance specified in subdivision (k) of Class II of Section 59 of the Act, namely:

Section 2.

(k) To become surety or guarantor for any person, copartnership or corporation in any position or place of trust or as custodian of money or property, public or private; to become a surety or guarantor for the performance by any person, co-partnership or corporation of any lawful obligation, undertaking, agreement or contract of any kind, except contracts or policies of insurance, to become surety or guarantor for the performance of insurance contracts where surety bonds are required by states or municipalities. The business covered by this subsection (k) shall be considered as fidelity and surety obligations and construed as such regardless of any other classification contained in this act to the contrary.

ARTICLE VII

Business Plan

The plan or principle on which the business of the Corporation shall be conducted is that of a stock company engaged in writing the kind of insurance and reinsurance specified in subdivision (k) of Class II of Section 59 of the Act.

On July 22, 1969, the Indiana Secretary of State certified the filing of AFIC's articles of incorporation under the State's insurance act. The articles were approved by the State insurance commissioner who, on September 2, 1969, issued a certificate of authority to AFIC to act as a surety

or guarantor in accordance with its articles. This authority was continued by means of annual recertification at least through the years in issue. Pursuant to these certificates AFIC entered into surety and guaranty contracts in Indiana, including contracts of criminal bail. AFIC received authorization from the insurance regulatory bodies of other States to conduct one or more lines of business, including bail bonding, beginning with the indicated dates during or preceding the years in issue:

State	Beginning date	State	Beginning date
Kentucky	11/30/70	Utah	12/20/72
Texas	9/22/72	New Mexico	12/27/72

At the time this case was submitted, AFIC was authorized to do business in 29 States. Since July 1, 1970, AFIC has been authorized by the Treasury Department to qualify as sole surety in contracts of bail, recognizances, and other undertakings permitted or required by Federal law.

All of AFIC's bail bonding contracts were in substantially the following form:

ALLIED FIDELITY INSURANCE CO.

Indianapolis, Indiana

Appearance Bond

In .... Court, State of ....

State of ____________
vs. ________________
________________ } County of ....

Know All Men By These Presents:

That we, ... as principal and Allied Fidelity Insurance Co., as surety (Identified by attached Power of Attorney No. ....) are held and firmly bound unto the .... (court, city, county or state) .... in the sum of .... Dollars, for the payment whereof well and truly to be made we bind ourselves, our heirs, executors,

administrators, successors and assigns, jointly and severally firmly by these presents.

Signed and sealed this ...... day of ...., A.D. 19...

The condition of this obligation is such that if the said ...., Principal, shall appear at the next Regular or Special term of the ..(Name).. Court ....(Location).... to be held in and for said County to answer a charge of .... and shall appear from day to day and term to term of said Court and not depart the same without leave than this obligation to be void, else to remain in full force and virtue.

Taken before and approved by me:) ....(Seal)....(L.S.)

....	Allied Fidelity	
....	Insurance Co.	(L.S.)
By	Attorney-In-Fact	(L.S.)

This Bond Not Valid Unless Accompanied by an Individually Numbered Power of Attorney Properly Executed.

On March 16, 1972, AFIC's articles of incorporation were amended to permit it to insure a wide variety of casualty and other risks. A certificate of authority covering these additional lines of business was issued by the Indiana Insurance Commissioner on May 1, 1972. AFIC subsequently obtained similarly expanded authority in other States. From that date on, AFIC engaged in writing motor vehicle insurance in addition to its surety and bail bonding activities.

Since its incorporation, AFIC has filed annual statements, on the form approved and adopted by the National Convention of Insurance Commissioners, with the insurance regulatory bodies of the States in which it is authorized to do business, as required by the laws of those States. AFIC's internal method of accounting and its method of accounting for tax purposes have been consistent with the methods used on the convention statement and with generally accepted principles of accounting in accordance with accepted conditions or practices of insurance companies.

Under those principles, AFIC did not include in the income reported on the consolidated returns amounts referred to as "unearned premiums," i.e., prepaid insurance or surety premiums[2] allocable pro rata to that portion of the contract term extending beyond the end of the taxable year in question.[3] Also in accordance with principles of insurance accounting, AFIC claimed a deduction in computing taxable income for amounts referred to herein as "unpaid net losses" and "unpaid loss adjustment expenses." "Unpaid net losses" consisted of claimed but unpaid estimated losses reduced by any portion thereof recoverable by contractual agreement, and/or estimates of such losses which had been incurred but not claimed by the end of the year. "Unpaid loss adjustment expenses" were estimates of unpaid expenses allocable to unpaid loss claims and estimated unreported losses. AFIC also included in its 1972 income dividends on stock of unrelated corporations in the amount of $874.75 which had been declared but not paid by the end of the taxable year.

AFIC's unearned premiums, unpaid net losses, and unpaid loss adjustment expenses were as follows for the years in issue:

Line of business	Unearned premiums		Unpaid net losses		Unpaid loss adjustment expenses[1]
	1971	1972	1971	1972	1972
Surety—bail ...	—	—	$41,924.83	$74,023.42	—
Automobile insurance	—	$ 98,445.99	—	6,300.88	$985.60
Fidelity and other surety ..	$12,908.93	25,530.86	554.92	4,948.32	—
Totals	12,908.93	123,976.85	42,479.75	85,272.62	985.60

[1] No unpaid loss adjustment expenses were reported for 1971.

[2] Any references herein to "insurance," "insurance premiums," or "premiums," or the use of similar phrases are for convenience only and are not to be accorded substantive significance unless the context so indicates.

[3] Amounts received as payment for bail bonds were treated by petitioner as being fully earned at the time of receipt, i.e., they were not prorated.

AFIC wrote net premiums allocable to its various lines of business in the following amounts before, during, and after the years in issue:

	1969	1970	1971
Surety—bail ...	$34,075.41	$189,800.66	$255,463.65
Automobile insurance	—	—	—
Fidelity and other surety .	—	15,538.50	26,156.80
Totals	34,075.41	205,339.16	281,620.45

	1972	1973	1974
Surety—bail ...	$280,446.01	$ 455,680.04	$ 555,603
Automobile insurance	115,378.78	1,159,352.06	1,308,884
Fidelity and other surety .	44,836.12	96,790.24	110,440
Totals	440,660.91	1,711,822.34	1,974,927

AFIC has engaged in no activity other than the above lines of business and the investment and reinvestment of its assets since its incorporation, and such activities produced all of its income during the years in issue.

Respondent determined that AFIC was not an insurance company during the years in issue. Accordingly, he contends that petitioner's taxable income was understated by the amount of AFIC's reserves for unearned premiums, unpaid net losses, and unpaid loss adjustment expenses, and overstated by the amount of declared but unpaid dividends reported.[4] Petitioner argues that AFIC was taxable as an

[4] For 1972, respondent increased petitioner's taxable income by the amount of the increase in the unearned premium and unpaid net loss accounts over the corresponding items at the close of 1971. For 1971, he included the entire closing balance of each account in income, disregarding opening balances of $9,435.57 and $6,400, respectively. If respondent is sustained in the position which he takes on the issues involved herein, this action also was proper. See sec. 481; *Hagen Advertising Displays, Inc.*, 47 T.C. 139 (1966), affd. 407 F.2d 1105 (6th Cir. 1969).

insurance company, or if not that its accounting method nevertheless clearly reflected income.

We are provided with no helpful, freestanding definitions of the terms "insurance" and "insurance company" for Federal tax purposes. It is clear that our decision is not controlled by nontax classifications and that characterization of particular corporations depends not on labels or certificated powers but on the character of the business actually conducted and that, in the absence of other guides, we should presume Congress to have used words in their ordinary and commonly understood sense. *Haynes* v. *United States*, 353 U.S. 81 (1957); *Helvering* v. *LeGierse*, 312 U.S. 531 (1941); *Bowers* v. *Lawyers Mortgage Co.*, 285 U.S. 182 (1932); sec. 1.801-1(b), Income Tax Regs. Outside the tax field, definitions of "insurance" are as varied as the purposes for which they are sought. See, e.g., *S.E.C.* v. *Annuity Life Insurance Co.*, 359 U.S. 65 (1959); *Jordan* v. *Group Health Assn.*, 107 F.2d 239 (D.C. App. 1939); *Meyer* v. *Building & Realty Service Co.*, 209 Ind. 125, 196 N.E. 250, 100 A.L.R. 1442 (1935); Note, "An Analysis of 'Insurance' and 'Insurance Corporation,'" 36 Colum. L. Rev. 456 (1936). The parties apparently agree that AFIC was primarily engaged in the business of acting as surety on bail bonds during the years in issue, and that it can be considered an insurance company only if the contracts made in the course of that business are insurance contracts. See *Columbia Title Insurance Co.*, 3 T.C. 1099 (1944).

In resolving this issue, we are unable to ascribe much significance to the fact that AFIC's bail bonding business was subject to regulation under the insurance laws of the various States in which it did business. Such regulation amounts to no more than a recognition that a corporate bail bondsman is ordinarily an insurance or surety company, not that bail bonding is insurance. Cf. *Louisville Title Co.* v. *Lucas*, 27 F.2d 413 (W.D. Ky. 1928). Professional bondsmen who are individuals frequently are not regulated under State insurance codes. *State* v. *Fishman*, 2 Conn. Cir. 83, 194 A.2d 725 (App. Div. 1963); *Portnoy* v. *McNamara*, 8

Ore. App. 115, 493 P.2d 63 (1972). Cf. *Sims* v. *Manson,* 25 Wis.2d 110, 130 N.W.2d 200 (1964).

In common understanding, an insurance contract is an agreement to protect the insured (or a third-party beneficiary) against a direct or indirect economic loss arising from a defined contingency. The insurer undertakes no present duty of performance but stands ready to assume the financial burden of any covered loss. 1 Couch, Insurance 2d, sec. 1:2 (1959). An essential feature of insurance is this assumption of another's risk of economic loss. 1 Couch, *supra,* sec. 1:3. By contrast, the principal obligation of the bail surety at common law was to produce the defendant at trial, an obligation for which the monetary bond was merely an assurance of, or inducement to, performance. *United States* v. *Ryder,* 110 U.S. 729, 734 (1884). Broad powers over the defendant's person were conferred upon the surety to aid in the performance of this duty, including the power to arrest. His undertaking thus resembled a contract to perform services—to stand in the jailer's shoes as custodian of the accused—rather than a contract of insurance. If the defendant failed to appear for trial, the surety's bond was forfeited, not to reimburse the State for the loss of the defendant's person but as a penalty for the surety's own failure to perform.

Petitioner points to language in some judicial opinions to support its contention that the foregoing model of the bail system is outdated. In *Leary* v. *United States,* 224 U.S. 567, 575-576 (1912), the Supreme Court stated:

> The distinction between bail and sureytship is pretty nearly forgotten. The interest to produce the body of the principal in court is impersonal and wholly pecuniary. If * * * the bond was for $40,000, that sum was the measure of the interest on anybody's part, and it did not matter to the Government what person ultimately felt the loss so long as it had the obligation it was content to take. * * *

In a similar vein is *United States* v. *Davis,* 202 F.2d 621, 625 (7th Cir. 1953):

> The bond is a contract between the surety and the government that if the latter will release the principal from custody the surety will undertake that the principal will appear personally at any specified time and place to answer. * * * When [the bondsman] writes a bond he assumes the great risk involved if his faith is misplaced in the person who executes the bond as principal. * * *

Petitioner argues that these cases envision a quite different role for the surety—that of simply guaranteeing payment of any forfeiture which might be incurred by reason of the defendant's nonappearance.

Petitioner's attempt to seize upon the foregoing language, obviously uttered in a nontax context, is of no avail. Most courts have not followed *Leary's* de-emphasis of the bondsman's personal obligation. Modern cases continue to assert that payment of the bond is not a substitute for performance of the surety's obligation to produce the defendant. *Continental Casualty Co.* v. *United States,* 314 U.S. 527 (1942); *Concord Casualty & Surety Co.* v. *United States,* 69 F.2d 78 (2d Cir. 1934); *United States* v. *Melville,* 309 F. Supp. 824 (S.D.N.Y. 1970). See also *United States* v. *Field,* 193 F.2d 92, 99 (2d Cir. 1951). The most that can be said is that the surety undertakes that the defendant will appear for trial or, alternately, that the amount of the bond will be forfeited. *In re Lexington Surety & Indemnity Co.,* 272 N.Y. 210, 5 N.E.2d 204 (1936). The latter is subordinate and incidental to the former. Cf. *Bowers* v. *Lawyers Mortgage Co., supra.* The focus of the bail system remains on balancing the accused's interest in personal liberty against the giving of adequate assurance of his presence during the criminal proceedings (*Stack* v. *Boyle,* 342 U.S. 1 (1951)), not on protecting the Government against economic loss. Thus, the surety is still regarded as contracting principally

to assume the Government's duty of supervising the defendant, rather than to compensate it for an economic loss. Although in form petitioner undertook to pay the amount of the bond if the defendant did not appear and did not pay, substantively petitioner had a direct obligation and the risk to which it subjected itself was the risk of failure in its own duty; this is not a risk assumed from another, as in an insurance contract. In any event, even if we were to view the obligation as being that of the defendant himself with petitioner as being only contingently responsible, the further requirement that the risk involved be one of economic loss would still not be met.

In sum, AFIC's bail contracts were not insurance and AFIC was not an insurance company during the years in issue.[5]

We now turn to petitioner's alternative argument that, notwithstanding AFIC's failure to qualify as an insurance company, its method of accounting clearly reflected income and was improperly disregarded by respondent. Section 446 provides:

> (a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of

[5] The parties have framed their arguments in generalities, and our opinion is shaped accordingly. Consequently, we need not and do not accord an unqualified blessing to the categorical position taken by respondent in Rev. Rul. 68-101, 1968-1 C.B. 319.

The record shows that the nature of AFIC's business was changing during the years in issue and afterward. Petitioner represents on brief that our decision herein will be determinative of AFIC's tax classification for subsequent years; however, we express no opinion on that issue.

> taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

If petitioner's method of reporting clearly reflected AFIC's income, then respondent had no authority under this statute to require the use of a different method. On the other hand, if that method did not clearly reflect its income, respondent's adjustments will generally be sustained. *All-Steel Equipment, Inc.* v. *Commissioner,* 467 F.2d 1184 (7th Cir. 1972), affg. on this issue and revg. in part on other grounds 54 T.C. 1749 (1970). See also *Fort Howard Paper Co.,* 49 T.C. 275 (1967).

The gist of petitioner's argument is that, whatever the formal label applied to AFIC, its business was conducted and regulated as an insurance business and should be taxed as such.[6] However, sound commercial accounting is not necessarily the same as proper tax accounting (*American Automobile Assn.* v. *United States,* 367 U.S. 687 (1961); *Franklin Life Insurance Co.* v. *United States,* 399 F.2d 757 (7th Cir. 1968)) and the favored treatment accorded insurance companies by the Internal Revenue Code is not to be extended by analogy to others not qualifying as such. *Brown* v. *Helvering,* 291 U.S. 193 (1934). Cf. *Wayne Title & Trust Co.,* 16 T.C. 924 (1951), affd. 195 F.2d 401 (3d Cir. 1952). Nor does section 1.832-4(a)(2), Income Tax Regs., providing that "The underwriting and investment exhibit is presumed to reflect the true net income of the [insurance] company," permit AFIC to adopt wholesale the method of accounting specified in section 832. The "presumption" referred to is rooted entirely in and draws its sustenance from section 832, which we have held inapplicable to AFIC, and cannot successfully be transplanted or cultivated by petitioner. Cf. *Franklin Life Insurance Co.* v. *United States,* 399 F.2d at 760-761; *Hanover Insurance Co.,* 65 T.C. 715, 718 (1976).

[6] It is stipulated that petitioner's automobile insurance policies, to which some of the adjustments in question are attributable, are "contracts of insurance."

It remains to be determined whether the individual adjustments made by respondent were necessary to clearly reflect AFIC's income.

The first challenged item is AFIC's reserve for unearned premiums, none of which were attributable to AFIC's bail contracts. Amounts allocated to this account, and therefore excluded from income, represented premiums actually received with respect to insurance and fidelity and surety contracts but attributable to that portion of the contract term extending beyond the year in question. Although such premiums were allocated to a "reserve," they were subject to AFIC's unfettered control on receipt and were not impressed with any trust. Ordinarily they would have been considered income to a noninsurance company in the year of receipt. *American Automobile Assn.* v. *United States, supra; Wayne Title & Trust Co., supra.*

Petitioner relies heavily on *Artnell Co.* v. *Commissioner,* 400 F.2d 981 (7th Cir. 1968), in which the Seventh Circuit (to which appeal would lie herein) held that deferred reporting of receipts attributable to the taxpayer's promise to perform in a later year does not necessarily distort income where the time for such performance is definite and fixed. In contrast, it cannot be said that an obligation to pay any loss in respect of contracts covered by these unearned premiums was fixed either as to the existence of a liability or the time or amount to be paid. Thus, the situation does not fit within the *Artnell* rationale. Much more analogous are the situations of the taxpayers in *Schlude* v. *Commissioner,* 372 U.S. 128 (1963), *American Automobile Assn.* v. *United States, supra,* and *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180 (1957), all of whom were required to report currently prepaid income allocable to indefinite future performance. Compare *Standard Television Tube Corp.,* 64 T.C. 238 (1975). Rev. Proc. 71-21, 1971-2 C.B. 549, is of no assistance to petitioner. By its own terms, it applies strictly to contracts to perform future services. An insurance or surety contract is a contract to pay money,

not to perform services. Cf. *Standard Television Tube Corp., supra.* Petitoner may not exclude from AFIC's income any amount of unearned premiums.

Finally, we deal with AFIC's claimed deductions for unpaid net losses and unpaid loss adjustment expenses. These accounts reflected estimates of the company's liability on losses, which were claimed but unpaid or were incurred but not reported at the end of the taxable year, and of anticipated allocable expenses.

The parties have stipulated that "unpaid net loss" represents "a claimed but unpaid estimated loss less any portion thereof recoverable by contractual agreement and/or an estimate of such a loss which has not been claimed" and that "unpaid loss adjustment expenses" represent "estimates of unpaid allocated expenses attributable to unpaid loss claims and estimated unreported losses." Thus, the accounts in question include losses (claimed and unclaimed) and expenses related thereto as to which AFIC might contest the existence of a liability, as well as recognized losses as to which the amount of the loss might not be capable of being fixed with reasonable accuracy. Sec. 1.461-1(a)(2), Income Tax Regs. We have no evidence which would permit us to allocate *individual* items among the various categories of losses. Thus, *Crescent Wharf & Warehouse Co.* v. *Commissioner,* 518 F.2d 772 (9th Cir. 1975), revg. and remanding 59 T.C. 751 (1973), where only *uncontested* claims for workmen's compensation were involved, has no application.[7]

Petitioner misconceives the thrust of the cases it cites in support of these deductions, all of which allowed deduction of separately established liabilities, reasonably calculable in amount, and are consistent with the above-cited regulation. It has long been held that no deduction is allowable with respect to estimated or contingent losses or expenses. *Brown*

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[7] We note that the Ninth Circuit Court of Appeals remand was "for the purpose of determining whether the amounts of liability can be determined with reasonable accuracy." See 518 F.2d at 775.

v. *Helvering, supra; World Airways, Inc.*, 62 T.C. 786 (1974), on appeal (9th Cir., May 20, 1975). This principle is applicable even where the liability provided for is in the nature of an insurance loss. *Milwaukee & Suburban Transport Corp.* v. *Commissioner,* 293 F.2d 628 (7th Cir. 1961), affg. per curiam T.C. Memo. 1959-216, on remand from 367 U.S. 906 (1961); *Spring Canyon Coal Co.* v. *Commissioner,* 43 F.2d 78 (10th Cir. 1930); *Wayne Title & Trust Co., supra.* Whether or not the method of accounting followed by AFIC would clearly reflect its income on the average or in the long run, see *Hanover Insurance Co., supra,* its income *for the taxable year* was not clearly reflected by the deduction of losses neither paid nor demonstrably incurred, any more than it was by the exclusion of receipts subject to the company's unrestricted control and not ascribable to a fixed obligation to perform at a date certain. See p. 1077 *supra.* Since AFIC was not an insurance company, it stands on an equal footing with and is subject to the same annual accounting principles as other taxpayers. The claimed deductions must be disallowed.

We do not understand petitioner to argue for the inclusion in income of declared but unpaid dividends except as required to be consistent with its other arguments, which we have rejected. In any event, under the rules applicable to noninsurance company, accrual basis taxpayers, such dividends are taxable only in the year in which they are unqualifiedly subject to the recipient's demand, which, at least in the absence of other evidence, is the year of receipt. *Dynamics Corp. of America,* 392 F.2d 241 (Ct. Cl. 1968); *Commissioner* v. *American Light & Traction Co.,* 156 F. 2d 398 (7th Cir. 1946); *Frelbro Corp.,* 36 T.C. 864, 871-872 (1961), revd. on other issues 315 F.2d 784 (2d Cir. 1962).[8]

Respondent has conceded certain other adjustments in his determination. Accordingly,

Decision will be entered under Rule 155.

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[8] See also *Bay Ridge Operating Co.,* T.C. Memo. 1970-19.